Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:BRK:TL-N-1043-01
DRMirabito

date: April 4, 2001

to: Jeff Karoly, Case Manager, International
Attention: Larry Gabriel, International Examiner

from: DIANE R. MIRABITO
Attorney (LMSB)

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subject: [redacted]

This memorandum responds to your request for assistance of February 14, 2001. This memorandum should not be cited as precedent.

ISSUES

1. Whether [redacted] ([redacted]), an accrual taxpayer, must include in taxable income in each of the fiscal years ended [redacted] and [redacted] marketing fees in the total amount of $[redacted] earned under a distribution agreement?

2. Whether the marketing fees in issue should also be considered part of the capitalization of a subsidiary formed by [redacted]? (Issue raised by International Examiner)

3. Whether [redacted]'s deduction in the amount of $[redacted] for a legal settlement pertaining to the subject distribution agreement is allowable or should be capitalized? (Issue raised by International Examiner and its resolution depends on the conclusion reached on Issue 2.)

CONCLUSIONS

1. The total amount of marketing fees should be included in taxable income as proposed by the International Examiner.

2. We see no legal impediment to the position taken by the International Examiner.

3. We see no legal impediment to the position taken by the International Examiner.

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FACTS

The facts, as we understand them, are as follows:

On [redacted], [redacted] and [redacted] (the Distributor) entered into a Distribution Agreement (the Agreement)[1] containing these provisions:

1. [redacted] appointed the Distributor as its exclusive distributor of certain [redacted] (the Products) in a defined Territory, subject to certain nonrelevant limitations. Further, it granted to the Distributor the exclusive right to use its trademarks on the Products in connection with the promotion, marketing, licensing, and use of the Products in the Territory.

2. The Distributor agreed to use its best efforts to introduce, promote, market, license, and service the Products in its Territory. In addition, the Distributor was to provide, at its expense, all necessary promotional and marketing materials and technical support for prospective and preexisting customers.

3. [redacted] alone determined "All prices and all terms and conditions of license agreements relating to the Products ...". However, the Distributor could change the prices and terms with [redacted]'s prior written approval.

4. [redacted] was to supply the Distributor with the Products, including [redacted], documents, promotional materials, price information, sample license agreements, and other information [redacted] deemed necessary for the Distributor to market the Products.

5. Upon the mutual written consent of the parties, additional [redacted] might be added. Such additions required the parties' mutual agreement on the payment of revised marketing fees.

6. The Agreement was to commence on [redacted] and continue for [redacted] months. Subsequently, the Agreement would be automatically renewed upon the same terms and conditions from year to year thereafter with an anniversary date of [redacted].

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[1] According to the International Examiner, [redacted] entered into similar distribution agreements with entities in Puerto Rico, Peru, and Saudi Arabia, but these agreements were not terminated in either of the subject fiscal years. Therefore, only our analysis of the first issue may pertain to these other distributors.

7. Upon termination of the Agreement, the Distributor was to cease holding itself out as [redacted]'s sales representative and return all technical data, lists, product samples, programs, catalogs, letters, papers, memoranda, drawings, designs, and all other sales and technical materials, including copies.

8. If the Agreement was terminated, the document provided certain payments to be made by or to [redacted] and the Distributor.

9. Within the defined Territory, [redacted] agreed not to engage in the distribution, sale, or lease of any [redacted] products which directly competed with the Products. Nor could [redacted] act as a sales agent or distributor of programs directly competing with the Products or directly or indirectly authorize any other person to engage in such acts.

On [redacted] the parties amended the Distribution Agreement to change the provisions on marketing fees and royalties. Under the amended Agreement,

1. The Distributor agreed to pay [redacted] no later than the first day of each succeeding Annual Period[2] a marketing fee for the right to market the Products. The Agreement provided, "The Marketing Fees shall be annual fees and shall accrue as an obligation of DISTRIBUTOR on the first day of each Annual Period ..." However, the Distributor could exercise its option to pay the marketing fees in equal quarterly installments.

2. If the Agreement was terminated during an Annual Period in which the Distributor had not fully paid the marketing fees due for that period, the balance was to become immediately due and payable.

3. The amount of the marketing fees was set by the Agreement for the Annual Period beginning [redacted] and was to increase yearly to an amount equal to [redacted]% of the fees applicable for the immediately preceding Annual Period.[3]

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[2] The period from [redacted] to [redacted] and the one-year periods from each succeeding [redacted].

[3] According to information you provided, marketing fees were due as noted:

Fiscal Year	Amount
[redacted]	$[redacted]

4. During each Annual Period, the Distributor was also to pay royalties to [redacted]. For the First Annual Period, a royalty of [redacted]% was due on amounts (the Eligible Amounts) equal to or less than $[redacted]; [redacted]% was due on larger amounts. In succeeding Annual Periods, the Eligible Amounts were to increase to an amount equal to [redacted]% of the Eligible Amount specified in the prior period. The Agreement specifically provided that the obligation to pay marketing fees remained independent of the obligation to pay royalties.

5. If the Distributor paid the marketing fees on the first day of the Annual Period, it was entitled to receive a credit against the royalties payable in an amount equal to the marketing fees actually paid.

6. If the Distributor opted to make quarterly payments of the marketing fees, and if the royalties earned and actually paid to [redacted] during any fiscal quarter equaled or exceeded the amount of marketing fees due, the Distributor did not have to pay marketing fees in that quarter.

7. If the royalties actually paid to [redacted] during a fiscal quarter were less than the marketing fees payable, the Distributor remained obligated to pay an amount equal to the difference between the amount of royalties paid and the marketing fees due that quarter.

8. If the royalties actually paid to [redacted] during any fiscal quarter exceeded the marketing fees due, the amount of the excess could be credited against the marketing fees due in the succeeding fiscal quarter.

In [redacted], [redacted] decided to replace the Distributor with a newly created subsidiary, [redacted], which it capitalized with $[redacted]. On [redacted], [redacted] terminated its agreement with the Distributor. The Distributor disputed [redacted]'s action and [redacted] ultimately sued the Distributor in the United States District Court, E.D.N.Y. The litigation pertaining to the marketing fees and royalties ended when the parties executed a Settlement Agreement with an effective date of [redacted]. The Settlement provided:

1. The Distributor was to transfer to [redacted] or [redacted] all monies relating to any [redacted] products or services received after the effective date except for amounts relating to the Statement of Account.

2. As of [redacted], the Distributor owed royalties in the amount of $[redacted]. Further, the parties recognized

that [redacted] had suffered other losses including unpaid marketing fees.

3. The parties agreed to settle the amounts due as noted in the immediate paragraph for the amount of $[redacted], which the Distributor acknowledged as its debt. According to the International Examiner, [redacted] did receive that amount.

By letter dated [redacted], [redacted] informed the Distributor that it had an outstanding balance of $[redacted] as of [redacted]. According to [redacted], this amount consisted of marketing fees due for the fiscal years [redacted] and [redacted] in the amounts of $[redacted] and $[redacted], respectively (a total of $[redacted]), and the royalties due of $[redacted]. The last figure appears to consist of the $[redacted] paid under the Settlement Agreement and $[redacted] listed by [redacted] as legal settlement expense.

Despite the several Agreements noted above, [redacted] has not reported as income these marketing fees owed by the Distributor. Rather, it "dummy" billed and recorded this income on its distributors revenue and accounts receivable summary. A [redacted] e-mail message from [redacted], [redacted], confirmed that the Marketing Funds invoices from the Distributor were never entered onto any accounting system and were not collected. Further, the message states that the "dummy" invoices would not show anywhere other than in the Distributor's records. In addition, according to the message, when the account was resolved through litigation, the invoices "were simply discarded as no credit was necessary."

According to the International Examiner, [redacted] used the unpaid marketing fees to determine the final price it paid to terminate the Distribution Agreement. Thus, [redacted] paid

Total Amount owed by Distributor	$[redacted]
Total Amount paid by Distributor under the Settlement Agreement	([redacted])
Total purchase price for Distributor's business	$[redacted]

He contends that the total purchase price should be added to [redacted]'s capitalization of [redacted] (initial capitalization of $[redacted]).

The International Examiner proposes these adjustments:

Item	[redacted]	[redacted]
Marketing fees due from the Distributor	$[redacted]	$[redacted]
Marketing fees due from other foreign distributors (total)	[redacted]	[redacted]
Total Adjustments	$[redacted]	$[redacted]

We understand that [redacted] did report the $[redacted] from the Settlement as royalty income.

To date, [redacted] has not provided any reason for its failure to report the marketing fees on its returns.

ANALYSIS

1. Status of the Marketing Fees

I.R.C. § 61 provides that gross income includes all income from whatever source derived. Gross income has been broadly defined to include all clearly realized increases in wealth over which the taxpayer has complete dominion. James v. United States, 366 U.S. 213, 219 (1961)(quoting Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955)).

In our opinion, the Distributor was to pay the marketing fee in return for the use of [redacted]'s trademarks and not for the sale of the [redacted] to the Distributor[4] even though [redacted] was to provide the Products and other marketing materials. Without the use of the trademarks, the Distributor could not legally market any of the [redacted]. In addition, the amount of the fee was fixed in the amended Agreement and did not depend upon the amount of the Products sold. This fixed amount contrasts with the computation of the royalties, which was based upon a percentage

[4] Even if the marketing fees represent prepaid income for the sale of the Products to the Distributor, prepaid income may not be deferred on the theory that it has not yet been earned through the performance of services, delivery of goods, or other consideration. Chesapeake Financial Corporation v. Commissioner, 78 T.C. 869 (1982).

of the Eligible Amount, defined as amounts invoiced by the Distributor to customers for licenses or maintenance of the Products and included all revenues derived from the Products. Further, the Agreement provided that: (1) the marketing fee was "for the right to market the Products"; (2) if the Agreement terminated during an Annual Period, any unpaid fee balance was to become immediately due and payable; and (3) if the parties terminated the Agreement, the Distributor was to cease holding itself out as [redacted]'s sales representative and return all [redacted]'s materials.

Generally, income is to be included in gross income for the taxable year in which it is actually or constructively received unless includible for a different year under the taxpayer's method of accounting.[5] I.R.C. § 451(a). When an accrual taxpayer such as [redacted] must report income is governed by the "all events" test. Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir.), cert. denied sub nom Hilton Hotels Corp. v. United States, 459 U.S. 1036 (1982) (citing United States v. Anderson, 269 U.S. 422 (1926)); Treas. Reg. § 1.446-1(c)(ii). Under this test, income accrues and must be reported when (1) the taxpayer has a fixed right to receive the income, and (2) the amount may be determined with reasonable accuracy. Resale Mobile Homes, Inc. v. Commissioner, 92-1 U.S.T.C. par. 50,282 (10th Cir.), aff'g 91 T.C. 1085 (1988), cert. denied, 506 U.S. 873 (1992); Spring City Foundry Company v. Commissioner, 292 U.S. 182 (1934). We think that the amount of the marketing fees due [redacted] are accurately determined under the amended Agreement. Therefore, we will analyze only when [redacted] had a fixed right to receive the marketing fees.

Usually, income accrues when the right to it becomes absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment. Nothing in the Agreement appears to restrict [redacted]'s use of the marketing fees and [redacted]'s retention of the payment does not appear to depend upon any future purchases by the Distributor. Further, the mere fact that some portion might have to be refunded in the future in the event of cancellation (such as termination of the Agreement) does not affect its quality as income. Brown v. Helvering, 291 U.S. 193 (1934). Thus, accrual is proper when amounts become due and payable, even though the service for which the sums were to be paid had not been performed. Flamingo Resort, 664 F.2d at 1390.

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[5] The doctrine of constructive receipt does not apply to accrual method taxpayers. Harbor Plywood Corporation v. Commissioner, 14 T.C. 158 (1950), aff'd per curiam, 187 F.2d 734 (9th Cir. 1951).

In this case, [redacted] ultimately sued the Distributor in order to collect the subject fees. However, it is when the taxpayer acquires the fixed right to receive income, and not the time of actual receipt, that controls under the accrual method. See Commissioner v. Hansen, 360 U.S. 446 (1959). Moreover, legal enforceablility, while relevant in determining when a right to income is fixed for accrual basis tax accounting purposes, is not required for accrual. Flamingo Resort, Inc., 664 F.2d at 1391. Further, the fact that a taxpayer cannot presently compel payment does not control when the income accrues. Resale Mobile Homes, supra. In addition, under the terms of the Agreement, we do not think that the mere circumstance of [redacted] filing suit served to defer accrual of the marketing fees. See Petty v. Commissioner, T.C. Memo. 1981-285.

Please note that we do not think that the provision for quarterly payment of the marketing fees should change the fact that the market fees accrued in full on the first day of each Annual Period. The amended Agreement specifies that the marketing fees shall be annual fees and that the payment of quarterly fees is optional. Thus, [redacted] appears to be accommodating the Distributor by agreeing to accept quarterly payment of the fees. In addition, if the Agreement was terminated before the Distributor fully paid the fees due for that Annual Period, the balance was to become immediately due and payable. Accordingly, we do not analyze the accrual of this income under any contract installment provisions. Alternatively, the quarterly payment schedule may be viewed as a ministerial act that did not defer accrual of the income. See Frank's Casing Crew and Rental Tools, Inc. v. Commissioner, T.C. Memo. 1996-413 (citations omitted).

According to its internal e-mail message, [redacted] dummy billed and recorded this income on its revenue and accounts receivable summary. However, these invoices were never entered onto any accounting system and were not collected. Rather, they were discarded without credit when the Distributor's account was resolved through the lawsuit. Nonetheless, the facts and the substance rather than the form of a transaction or bookkeeping entries determines taxability. Resale Mobile Homes, supra.

Please note that § 446(b)[6] allows the Commissioner broad discretion regarding whether a particular method of tax accounting reflects income accurately. Further, his determination is entitled to more than the usual presumption of correctness and should not be interfered with unless clearly

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[6] The term "method of accounting" includes the accounting treatment of any item. Resale Mobile Homes, Inc. v. Commissioner, 92-1 U.S.T.C. par. 50,282 (10th Cir. 1992).

unlawful. Should [redacted] seek to litigate this issue, it would have to prove that inclusion of the marketing fees as fixed in the Agreement is arbitrary and capricious, lacking a sound basis in fact and law. JFM, Inc. and Subsidiaries v. Commissioner, T.C. Memo. 1994-239 (citations omitted).

2. Capitalization of [redacted]'s Subsidiary

As noted above, the International Examiner proposes to add to the initial capitalization of [redacted] the amount of $[redacted], representing an amount [redacted] essentially paid to terminate the Agreement. We recognize for purposes of the discussion below that [redacted] did not make any payments to the Distributor upon its termination of the Agreement, but we view CA's acceptance of $[redacted] in lieu of the full amount of marketing fees and royalties due under the amended Agreement at the time of termination as equivalent to an out-of-pocket expenditure.

Once the Agreement was ended, [redacted] was free to use its trademark to sell the Products through its newly created subsidiary, without being tied or subject to the potential risks of using a middleman. Essentially, as more fully discussed below, [redacted] was free to create an asset having a useful life extending substantially beyond one taxable year. However, since the created asset was not subject to depreciation, depletion, or amortization, [redacted] cannot recover the cost of terminating the Agreement until it disposes of the subsidiary. Thus, the International Examiner's position should eventually match expenses and revenues as nearly as possible in these circumstances.

According to Treas. Reg. § 1.446-1(c)(ii), a liability related to the creation of an asset having a useful life extending substantially beyond one taxable year should be taken into account through capitalization under I.R.C. § 263. That section provides that no deduction shall be allowed for any amount paid out for betterments made to increase the value of any property. The seminal case discussing § 263 is INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). The Supreme Court determined that capitalization is the norm and through this section the Code endeavors to match expenses and revenues for the taxable period to which they are properly attributable, resulting in the most accurate calculation of net income. Further, capital expenditures are not exhaustively enumerated in the Code. The Court also discussed what constitutes a capital asset, holding that while expenditures that create or enhance separate and distinct assets are to be capitalized, these are not the only expenses subject to that rule. Moreover, the Court held that a taxpayer's realization of benefits beyond the year of expenditure is undeniably important in deciding whether the expense must be capitalized. Thus, courts have characterized an expenditure as capital because "'the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year.'" (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8^{th} Cir. 1964)); Dow Corning Corporation v. Commissioner, 53 T.C. 54 (1969)(section 263 does not require the acquisition of a capital asset; betterments made to increase the value of any property or estate are all that is needed).

Treas. Reg. § 1.263(a)-2 gives as an example of a capital expenditure the cost of acquiring property having a useful life substantially beyond the taxable year. Capital expenditures may not be currently deducted but are recovered upon the sale of the property if the asset is not subject to depreciation, depletion, or amortization. Examples of capital expenditures include:

1. settlement payments made to gain control of a business. See Newark Milk & Cream Co. v. Commissioner, 10 B.T.A. 683 (1928), aff'd, 34 F.2d 854 (3d Cir. 1929); Wood County Telephone Company v. Commissioner, 51 T.C. 72 (1968);

2. payments made as part of a plan to eliminate an unwanted middleman. Darlington-Hartsville Coca-Cola Bottling Company, Inc. v. United States, 393 F.2d 494 (4^{th} Cir.), cert. denied, 393 U.S. 962 (1968)[7];

3. payment to bondholders to terminate an option. The Wigmore Realty Company v. United States, 104 F. Supp. 439 (N.D. Ohio 1952)("... where the lessor voluntarily acts to induce the lessee to give up the lease before the end of the term, the amount paid in consideration for the lessee's agreeing to cancellation is held to be a capital expenditure which must be prorated over the term.");

4. elimination of competition by acquiring its franchise.

[7] Please note that the Fourth Circuit subsequently held that to the extent that Darlington-Huntsville stood for the proposition that a one-year standard existed for distinguishing between capital and current costs, it no longer was authoritative. NCNB Corporation v. United States, 684 F.2d 285 (1982). However, we do not cite Darlington-Huntsville for the one-year standard but rather for the proposition that payments made to eliminate a middleman are capital expenditures.

Eagle Pass & Piedras Negras Bridge Company v. Commissioner, 23 B.T.A. 1338 (1931);

5. payment for a release from personal liability on a promissory note. Kisska v. Commissioner, T.C. Memo. 1981-655;

6. acquisition of an unlimited right to use an internationally registered trademark. Dow Corning Corporation v. Commissioner, 53 T.C. 54 (1969);

7. payments made to protect ownership of stock. Harold Levinson Associates, Inc. v. Commissioner, T.C. Memo. 1997-536; Eisler v. Commissioner, 59 T.C. 634 (1973);

8. payments made to a lessee to terminate the lease prior to its expiration where the taxpayer reacquires rights it once possessed. Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974); and

9. acquisition of intangible contract rights. Hudgins v. Commissioner, 55 T.C. 534 (1970).

In addition, we note in further support of this position that the subsidiary was very thinly capitalized as [redacted] only contributed $[redacted] in creating [redacted].

According to the Agreement and the Settlement, New York law governed the rights, obligations, and relations of the parties thereunder. In addition, the Settlement provided that the parties submitted themselves to the jurisdiction of federal courts in the Eastern District of New York. Therefore, cases decided by the Court of Appeals, Second Circuit, are precedential. Since several of these cases have held certain payments not to be capital expenditures, they must be compared to the circumstances here.

In The Van Iderstine Company v. Commissioner, 261 F.2d 211 (2d Cir. 1958), the taxpayer made several lump sum payments to a supplier in consideration for the right for an indeterminate period to purchase all raw materials as the supplier might have at prices to be agreed upon in the future; the payments were made to insure a large and steady volume of raw materials essential to its business. The Second Circuit reversed the Tax Court's finding that the payments were expenditures made in acquiring intangible capital assets because it did not think the taxpayer had acquired any such rights under the vague terms of the agreement with the supplier. Rather, it had purchased only an expectation or hope that it would be preferred over other possible purchasers, and such a hope could not be considered a purchase of an intangible capital asset. Further, since no right had been acquired, the payment was made to protect and promote the taxpayer's business. We think [redacted]'s situation differs from these facts since it acquired much more than an expectation or hope-it reacquired the right to use its own trademark and thus market the Products itself. Essentially, [redacted] paid the Distributor to cease acting as its sales representative, return the Products, and transfer to [redacted] or [redacted] all monies relating to any [redacted] products or services received after [redacted].

After the Loft Candy Company lost a substantial amount of its business, it began an aggressive program of soliciting suburban independently operated retail outlets to sell its products by entering into contracts similar to franchise contracts. Again, the Second Circuit, in <u>Briarcliff Candy Corporation (formerly Loft Candy Corporation) v. Commissioner</u>, 475 F.2d 775 (2d Cir. 1973), reversed the Tax Court's upholding of the Commissioner's position that the taxpayer created capital assets through its efforts to maintain its sales and profits by creating, in its franchise division, a distribution system for its products through valuable agency contracts with independent retailers. The Circuit Court acknowledged that where the contributing factor enhanced an intangible capital asset of the new division of the same established company, the boundary between a taxable capital asset and an ordinary and necessary expense, incurred in carrying on a business, became imprecise. However, the Court decided that the taxpayer only used its sales personnel to sell the same product it had sold for many years through company-owned or leased retail outlets. Further, it found that not every new idea and every change of method in making sales, even in developing new sales territory, required a characterization of expenses as capital in nature. Ultimately, what Loft had done was to change its own internal organization to spread its sales into a new territory and such changes did not compare to the acquisition of a new additional branch or division to make and sell a new and different product. Rather, the taxpayer was stimulating its sales department and was still selling exactly the same products it had sold for decades. In addition, the Court rejected the Tax Court's finding that the agency contracts constituted capital assets; rather, it found the contracts indistinguishable from a contract of employment for a term of years and that they represented the recruitment of sales agents for a long established concern to sell the taxpayer's usual and regular product. Finally, the Court decided that the facts of the case brought it squarely within the principle that expenditures for the protection of an existing investment or the continuation of an existing business or the preservation of existing income from loss or diminution are not capital in nature. Again, we think the Court's holding does not apply here.

In our opinion, [redacted] did not merely redirect its own sales personnel to sell products it had sold for many years through a company-owned distributor or merely continue an existing business. Rather, it created a new division to directly sell its products to customers, something it had not done and could not legally do while the Agreement was in effect. Nor do we see the Agreement with the Distributor as akin to an employment contract. In addition, please note that Briarcliff was recently criticized as erroneously interpreting language from Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971), as requiring a new test for determining whether an expenditure was currently deductible or must be capitalized. Wells Fargo & Company v. Commissioner, 224 F.3d 874, 881 (8th Cir. 2000). According to the Eighth Circuit, the Second Circuit adopted a new "separate and distinct additional asset" test or a variation thereof which permitted necessary business expenditures to be fully deducted during the taxable year unless the expense created or enhanced a separate and distinct additional asset. We agree with the Eighth Circuit to the extent that Briarcliff used the distinct asset test as the INDOPCO Court stated, "It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263." 503 U.S. at 86-87. (emphasis in original)

We think two other Second Circuit cases are more applicable here. In American Dispenser Co., Inc. v. Commissioner, 396 F.2d 137 (2d Cir. 1968), the taxpayer made a lump sum payment to a competitor in return for an agreement that the competitor would not manufacture and/or market copies of the taxpayer's products. The Second Circuit found that an expenditure made to eliminate competition for many years to come should be considered an expenditure for the acquisition of a capital asset. "It is sufficient for our purposes that American was willing to pay a substantial sum in return for Continental's covenants. Moreover, even if the payment was made to avoid litigation, it still must be held to represent a capital outlay." Here, we view [redacted]'s acquisition of the Distributor's agreement to cease acting as its sales representative without further litigation as analogous to an elimination of competition for its subsidiary and thus within the scope of this decision.

Similarly, in Wise v. Commissioner, 311 F.2d 743 (2d Cir. 1963), the Court found a settlement made to preserve title to real property as a capital expenditure to be added to the basis of the property. [redacted]'s settlement could be seen as an action taken to reacquire its right to use its title to the Products and therefore also a capital expenditure.

In light of the above, we see no legal barrier to the position the International Examiner proposes.

3. Deductibility of Expenses Related to the Settlement

The origin and nature of an expense sought to be deducted, rather than the legal form, determines the applicability of I.R.C. §§ 162 or 263. Interstate Transit Lines, v. Commissioner, 319 U.S. 590 (1943). Courts have frequently held that an expenditure in connection with the acquisition of a capital asset is a capital investment and therefore not deductible as an ordinary and necessary expense of carrying on a business. Gaines v. Commissioner, T.C. Memo. 1982-731 (citations omitted). Since [redacted]'s claimed expense for a legal settlement relates to its acquisition of a capital asset as discussed above, again we see no legal reason not to take the position proposed by the International Examiner.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be different. If the facts change, this opinion should not be relied upon. Please note that under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

Should [redacted] provide you with its position on these issues, we will be happy to provide you with an additional analysis. Please contact Diane Mirabito at (516) 688-1744 if we may be of further assistance.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse

affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Jody Tancer
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By:____________________________
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